Mid-Year Outlook

At-A-Glance

The S&P 500 Total Return Index surged over 20% between April 8 and June 12, marking only the sixth time in 70 years such a rapid gain occurred.

International equities remain resilient, showing strength despite ongoing geopolitical tensions.

As of June 18 (the date of the June Fed meeting), the MSCI EAFE Index is up 5% year-to-date, compared to just a 1% gain for the S&P 500.

Growth stocks have regained momentum, fueled by rising demand for artificial intelligence. Related, utilities declined only 8% from the April 8 low and continue to benefit from increased energy needs.

The Russell 2000 Index Small Cap Index remains more than 10% below its 52-week high, but lowered expectations may set the stage for upside-surprises.

Bond yields rose across the curve, driven by inflation concerns, tariff announcements, and the unwinding of leveraged basis trades that hedge funds were engaged in.

As yields rose and equities fell, tariff escalation was paused—potentially signaling the market's influence on policy decisions.

With bonds and international equities outperforming U.S. stocks, balanced portfolios have generally outperformed the S&P 500 so far in 2025.

Risks Recoil as Stocks Rebound

As we enter the second half of 2025, investors are navigating a market environment shaped by both uncertainty and opportunity. While recent volatility—driven by tariff announcements, inflation concerns, and geopolitical tensions—has tested market resilience, the broader economic backdrop remains more stable than headlines may suggest. The labor market continues to show resilience, inflation is moderating, and global stimulus efforts are helping to support growth. These dynamics, while complex, offer a foundation for cautious optimism as we look ahead.

One of the most important factors to watch in the coming months is the outcome of ongoing trade negotiations. Currently, inflation is easing, but the impact of the tariffs could lead to a modest uptick in the coming months. The tariffs announced earlier this year introduced short-term disruptions, but they also opened the door to potentially more favorable trade terms.

If progress is made, it could ease inflationary pressures and give the Federal Reserve (Fed) flexibility to lower interest rates - supporting both consumer confidence and business investment. At the same time, inflation data remains relatively contained, and the Fed appears willing to act if economic conditions soften further. While the Fed has been reluctant to cut interest rates, it is now in a rate cutting cycle and will likely come to the rescue if the economy weakens.

From a market perspective, we are seeing a shift in leadership. International equities have outperformed U.S. markets year-to-date, supported by fiscal stimulus in Europe, rising inflation and corporate governance reforms in Japan, a weaker U.S. dollar and a rotation away from domestic growth stocks. Within the U.S., large-cap growth names have rebounded, while small and mid-sized companies may be poised for upside surprises as expectations reset. Fixed income markets have been volatile, but they continue to offer diversification benefits—especially if equity markets remain sensitive to policy shifts or geopolitical developments.

In this environment, staying diversified and focused on long-term goals is more important than ever. Structural trends like artificial intelligence (AI), infrastructure investment, and global supply chain realignment continue to create opportunities across sectors and regions. Your Cetera financial professional is here to help you navigate these evolving dynamics, ensuring your portfolio remains aligned with your personal objectives. While uncertainty may persist, thoughtful planning and disciplined investing remain the best tools for long-term success.

Economy

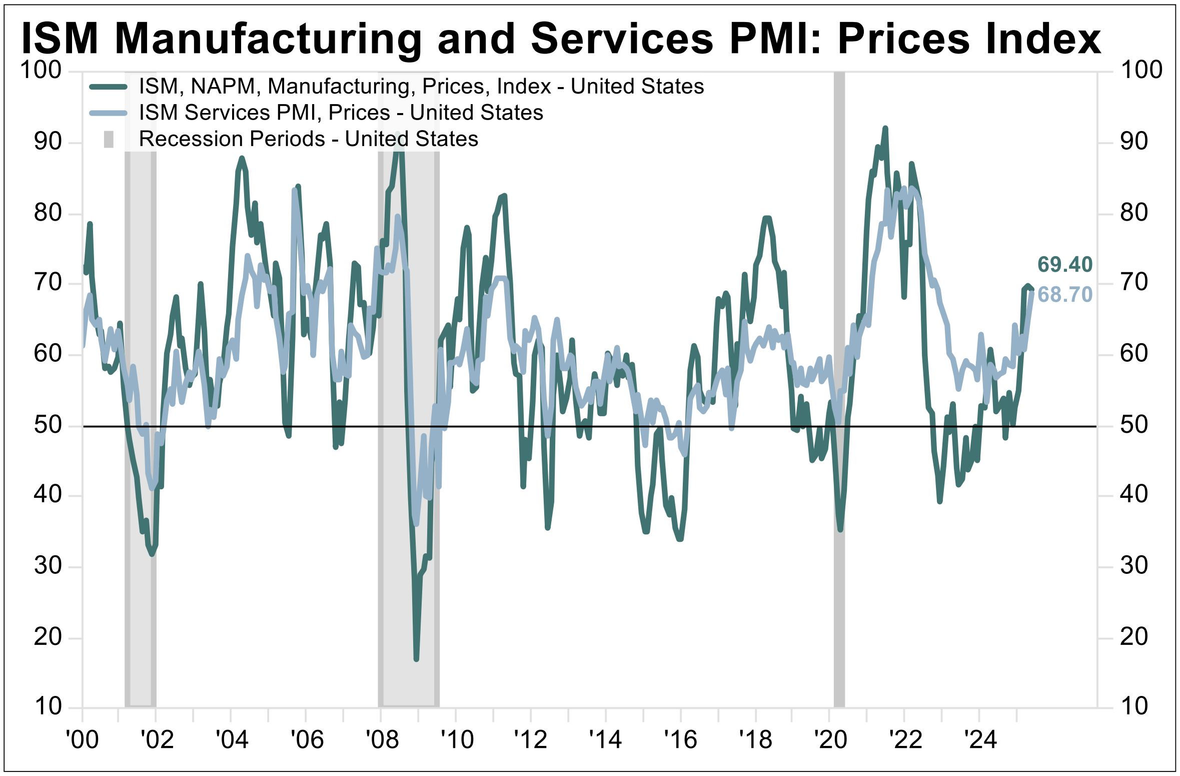
Risks had been growing heading into the second quarter. We spoke of concerns around the growth of artificial intelligence, looming tariffs, government spending cuts, and slowing economic growth. With the sweeping announcement of steep tariffs on April 2, tariffs took center stage. Equity markets, already in a correction (having fallen more than 10% from their peaks) saw further declines. Even with tariffs not yet enacted in the first quarter, GDP growth still proved to be slightly negative, as businesses stocked inventories. The administration ultimately delayed or lowered some tariffs and stock prices rebounded. It is easy to get whipsawed with the headlines, and while a lot has happened in the last quarter, a lot remains the same. Many of those underlying risks still lurk in the background.

Tariffs continue to be the main risk factor. Many of the tariffs were delayed, allowing time for negotiations, but it is still unclear whether countries will come to terms with them. Tariffs are hard to quantify, because it cannot be determined how much will be absorbed by the manufacturer, wholesaler, retailer or consumer. Additionally, there are substitution effects. Consumers and suppliers can choose to buy goods produced in another country to avoid a tariff. All these factors will play into how tariffs will impact inflation, corporate earnings, and economic growth. This uncertainty is why the Federal Reserve and corporations are delaying decisions until they can get more clarity. The Fed is hesitant to lower interest rates if inflation is about to pick up, while businesses are reluctant to expand operations and increase inventories if the economy is showing signs of weakness.

We are seeing the impact of tariffs on soft data, which is more forward-looking, but not as dependable as so-called hard data. Soft data includes surveys given to consumers and businesses to gauge how the economy is doing in real time. While hard data is quantifiable data, such as employment numbers and production levels, it takes time to measure these hard data points, and we do not get the data until after the fact. For instance, the U.S. Bureau of Economic Analysis will release second quarter GDP results on July 30, nearly a full month after the quarter ends. Furthermore, there likely will be further revisions over time.

Soft data, such as consumer confidence and sentiment surveys, have plummeted. The ISM Manufacturing and Services PMI indexes for New Orders are both in contraction as of May. These indexes also show rising price pressures as seen in **Figure 1**. Consumer surveys like the University of Michigan Survey of Consumers and the Conference Board's Consumer Confidence Survey are signaling the consumer is increasingly worried, particularly about inflation.

Figure 1: Rising Price Pressures



Source: Cetera Investment Management, FactSet, Institute for Supply Management (ISM). Data as of 5/31/2025.

While the pace of spending is moderating, hard data shows consumers are still spending, and consumer balance sheets are still strong. The Atlanta Fed's GDPNow model, which estimates GDP in real-time, is currently estimating second-quarter GDP growth will be a whopping 3.4% as of this writing. This seems unlikely and may end up closer to consensus estimates around 1%. Consumers will continue to spend if the labor market is still growing. The median projection in the Fed's June dot plot is for 2025 GDP growth to be 1.4%, down from 1.7% in their March projection.

The labor market is key, as it will determine the direction of the economy and the Fed's rate path. If the labor market weakens, the Fed will likely act sooner and lower rates. The Fed can be patient and watch to see how tariffs play out as long as the labor market remains intact. Currently, the unemployment rate is a respectable 4.2%. With job openings and unemployed job seekers near equilibrium, it will take longer for those looking for jobs to find them, but it should also keep a lid on wage inflation. Government hiring was a tailwind for job creation in the last few years, with government employment increasing by an average of 49,500 per month in 2023-2024. However, there has been a recent shift, with net government job growth increasing by just 1,000 jobs in the last four months. The good news is that the private sector has absorbed this lack of job growth, albeit at a moderate pace.

Inflation remains under control as the Consumer Price Index was 2.4% in May. The Fed's preferred measure of inflation, the core Personal Consumption Expenditures (PCE) price index, was 2.5% in April. Again, hard data takes time to measure, so these most recent data points are a bit dated. The Cleveland Fed attempts to measure inflation in real time in their Inflation Nowcasting model. They are estimating June year-over-year core PCE Price index to be 2.58%. While inflation seems to be under control, it would make sense that consumers do not feel this way. They are already struggling with high prices, so small amounts of inflation can feel more painful. With all that said, if tariffs remain in place, increased prices will eventually work their way into inflation reports. Initially, tariffs tend to be deflationary as higher prices impact economic growth and hurt the prices of economically sensitive commodities such as copper and oil. Taken together, these tend to lessen inflation. However, the higher prices of tariffs will work their way into key inflation reports as early as the June (set to be released in July).

Geopolitical risks are always a factor. The state of the world is constantly in flux, and we have conflicts in both Europe and the Middle East. The most recent flare up in the Middle East is concerning. While the human toll weighs on our minds, our focus in this outlook is the economic impact. An escalating conflict between Israel and Iran has implications for oil markets. Rising oil prices caused by supply chain worries will add to inflation as oil impacts transportation costs and gasoline prices. Geopolitical risks only add to the uncertainty for the Fed and economy.

However, there are reasons for optimism. If these risks subside, it bodes well for the economy. Ongoing tariff negotiations could ultimately result in fewer trade barriers than existed before negotiations began. After all, the point of increasing tariffs was to get better trade deals for the United States. Inflation is already largely in check. If tariff rates are negotiated lower, it will give the Fed room to cut interest rates and stimulate economic growth. Geopolitical events also tend to be short-lived in markets and the economic impacts are often isolated. These too can hopefully be resolved.

Summing It Up

Economic risks have been increasing, with tariffs emerging as the primary concern after the tariff announcement on April 2 which triggered a further market selloff. Though some tariffs have been delayed, they have increased uncertainty, affecting business and Fed decisions. Soft data shows declining confidence and rising inflation fears, while hard data. like spending and employment, are slowing but still healthy. The labor market, with 4.2% unemployment, is key to economic stability. Inflation is moderating, but consumers still feel the strain of high prices caused by previous bouts of inflation. Geopolitical tensions, particularly in the Middle East, are adding to uncertainty. However, if these risks ease, economic growth could rebound, supported by potential Fed rate cuts and better trade terms.

Equity Markets

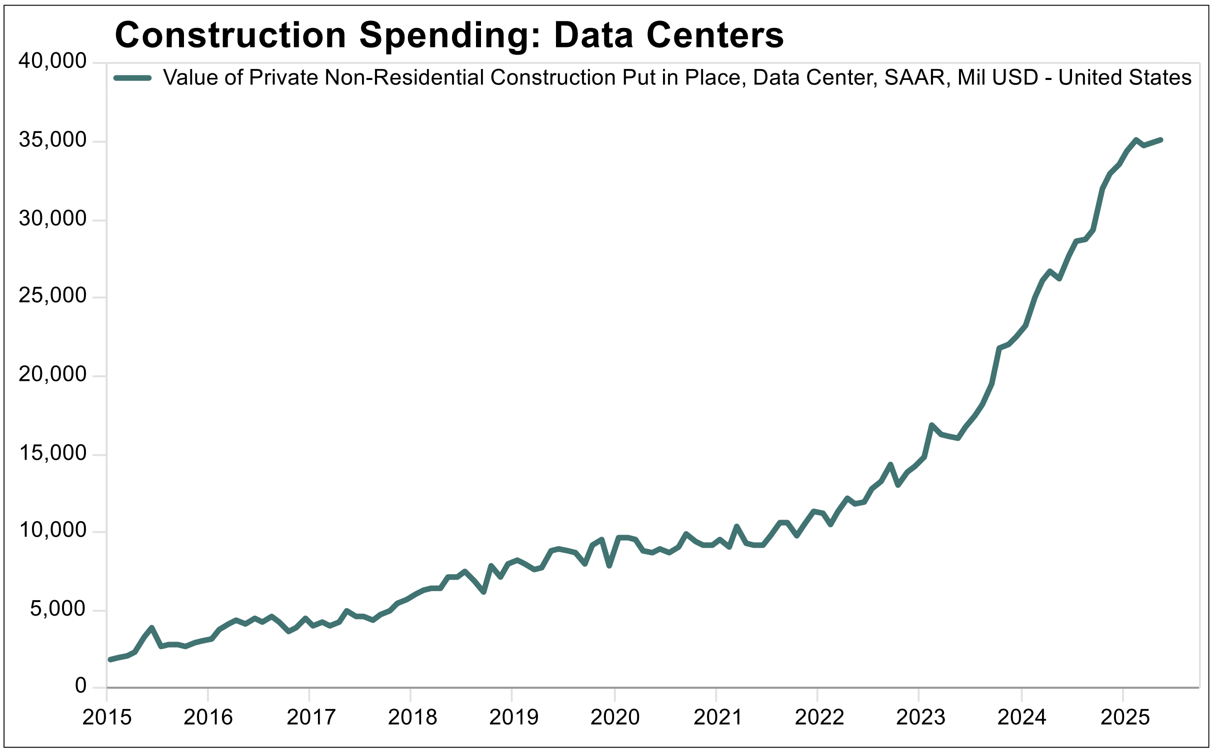
Volatility that began in the first quarter intensified in the second quarter as the Trump administration announced sweeping tariffs on April 2 that reignited fears of both recession and rising inflation. Geopolitical tensions took center stage ahead of earnings season, amplifying concerns about slowing global growth.

Yet, amid the turbulence, markets found a moment of reprieve. A pause in tariff escalation and a willingness to negotiate allowed cooler heads to prevail. The initial shock of higher tariffs began to fade, and the S&P 500 has since rebounded more than 20% from the April low, now approaching its all-time high set in February.

While earnings projections have moderated from the more optimistic outlook since the year began, growth remains positive. The tone has shifted from exuberance to cautious optimism. Notably, despite the largest quarterly outperformance by value stocks compared to growth stocks since 2001 in the first quarter, the second quarter correction saw growth stocks roar back to life. U.S. companies posted a 13% year-over-year earnings growth in the first quarter of 2025, underscoring the resilience of corporate fundamentals.

The AI theme that has driven markets higher in the past couple years will continue. While valuations can get stretched and there will be volatility around growth expectations, the overall theme will remain well into the future. Two sectors that have benefited recently are Technology and Utilities. Technology companies continue to signal strong demand for computing power, fueling infrastructure investments. Utility companies, often overlooked, have emerged as key beneficiaries—striking deals with hyperscalers to meet the surging energy demands of AI-driven data centers as seen in **Figure 2**. Eventually, as the AI revolution evolves, it will start to impact other sectors.

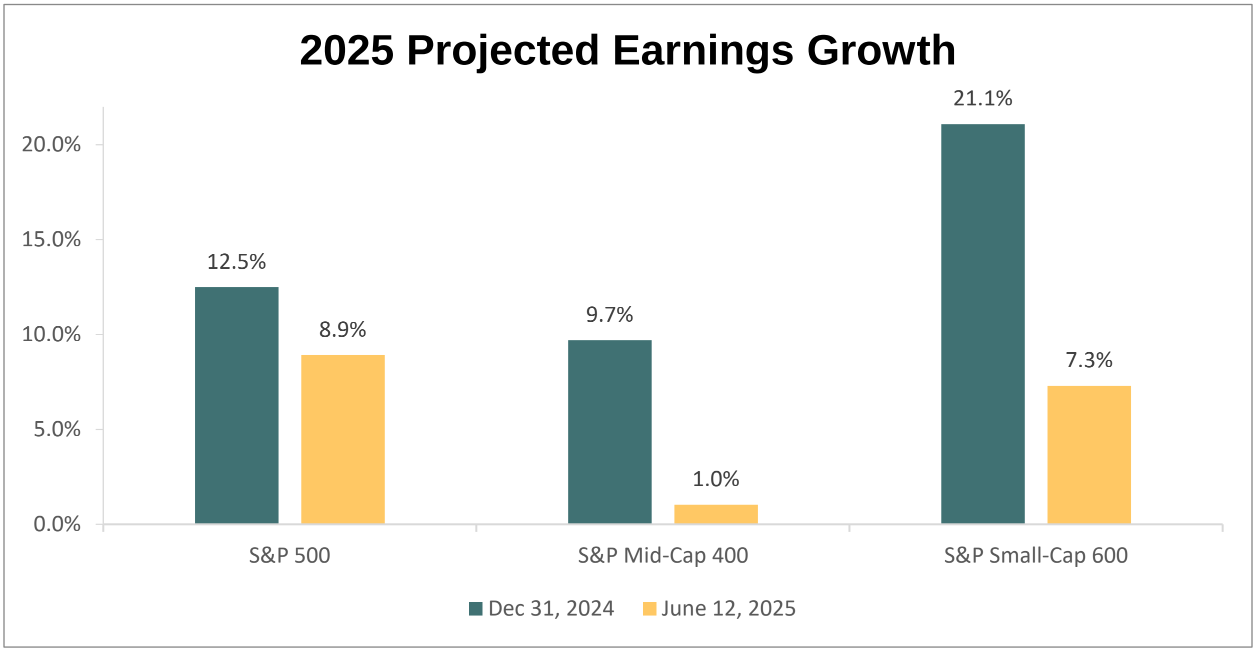
Figure 2: Data Centers Benefit from AI Boom



Source: Cetera Investment Management, FactSet, U.S. Census Bureau. Data as of 5/31/2025.

However, the recovery has not been uniform. Small and mid-sized companies are facing greater challenges, with earnings growth decelerating more sharply than their large-cap peers as seen in **Figure 3**. The Russell 2000 index of small cap stocks remains more than 10% below its 52-week high. Still, this underperformance may set the stage for upside surprises, as expectations have been reset to more achievable levels.

Figure 3: Falling Earnings Expectations



Source: Cetera Investment Management, FactSet, Standard & Poor's. Earnings growth is represented by the year-over-year change. 2025 figures are projected by FactSet. Data as of 6/12/2025.

International equities have been a surprising source of strength, defying the narrative that tariffs would disproportionately hurt global markets. The European Central Bank's rate cuts, a weakening U.S. dollar, fiscal stimulus, and a rotation away from U.S. equities have all contributed to positive momentum abroad.

Germany's defense sector has benefited from an increase in investment due to a pullback in U.S. military commitments along with pro-growth policies, while Japan's equity market remains strong, supported by ongoing shareholder reforms. Emerging markets are also gaining traction, buoyed by a lower dollar and a strategic pivot toward diversified trade partnerships aimed at enhancing economic resilience.

As we enter the second half of 2025, investors face a complex but opportunity-rich environment. While U.S. large-cap growth stocks have regained momentum, international equities continue to show strength, and small caps remain under pressure, though returns have been strong since April's low. Sentiment can shift quickly, highlighting the importance of maintaining a diversified portfolio.

To navigate this landscape:

- **Diversify Globally**: The fading dominance of U.S. markets highlights the need to rebalance toward international opportunities.
- **Prioritize Fundamentals:** Focus on resilient companies and sectors benefiting from structural trends like artificial intelligence and infrastructure.
- **Monitor Policy Shifts:** Markets remain highly reactive to tariffs and executive actions - policy clarity could shift sentiment quickly.
- **Be Selective**: Broad index exposure may lag. Active management and targeted strategies are better suited to capture dispersion.

In a world of rapid change, adaptability and thoughtful diversification remain essential for portfolio resilience.

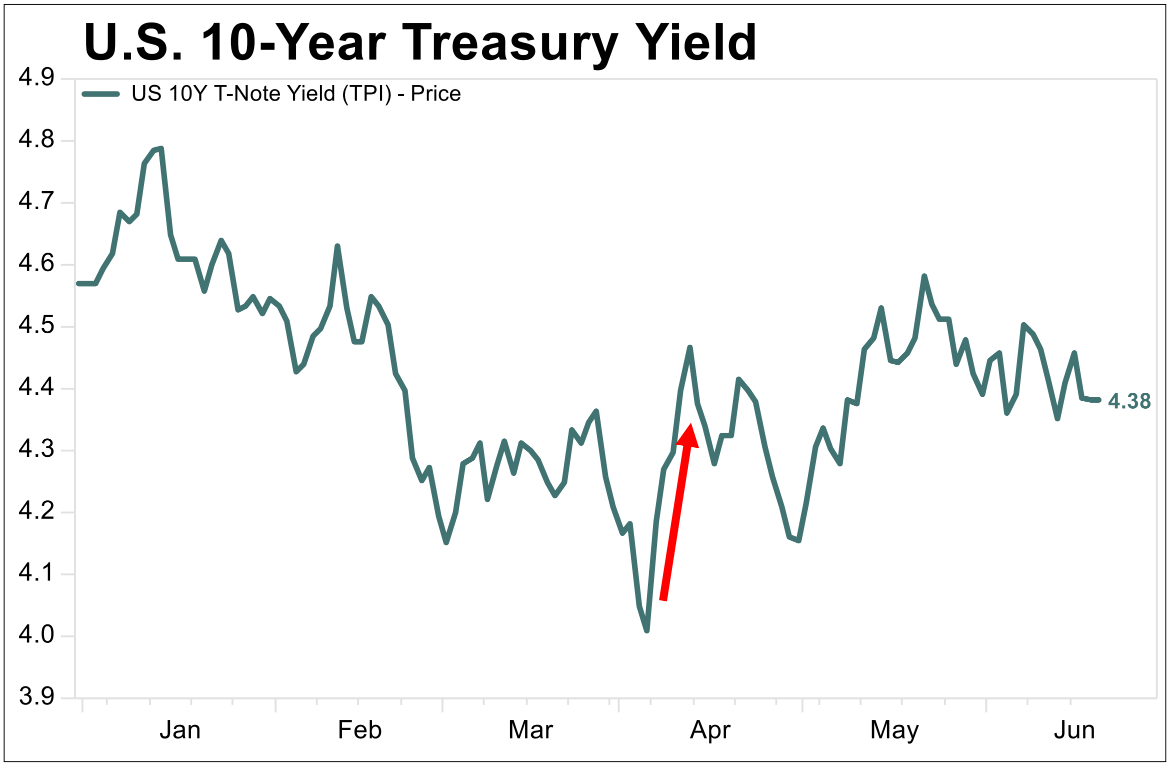
Fixed Income

The bond market's reaction to tariffs was largely unexpected, with yields spiking across the maturity curve following news of larger than expected tariffs. Prospects for higher inflation should drive up short-term Treasuries, but the tariffs impact on inflation may be temporary. Inflation is the change in prices and tariffs would only cause a one-time increase in prices unless the tariff rates continued to rise, which is unlikely. The 2-year Treasury yield spiked 0.3% on April 3rd, the largest intra-day move since the Great Financial Crisis in 2009. Shorter-term notes are tied closely to expected Fed Funds rate expectations, so this is understandable, as the market was pricing in fewer Fed rate cuts with the prospects of increased uncertainty around inflation.

The movements in longer-dated bonds were more perplexing and concerning. The bigger threat of the tariffs is likely to be economic growth, which should translate into lower longer-dated bond yields. Additionally, the stock market sell-off would likely have investors flocking to bonds for safety and thus driving prices up and yields lower. Initially, long-term bond yields did fall as expected on the tariff news but then started to sharply rise. The 10-year yield went from 4.01% on April 4th to 4.48% on April 11, as seen in **Figure 4**. This likely played into the Trump administration's decision to pause tariffs for 90-days to allow time for negotiations.

While there were fears foreign countries were selling U.S. Treasuries to drive up Treasury yields, this could not be confirmed. The consensus for this odd occurrence was that hedge funds were engaged in a trade that involved a lot of leverage. Hedge funds were involved in a so-called "basis trade", buying Treasury bonds while selling corresponding Treasury futures contracts. Due to the volatility around the tariffs, Treasury futures spreads widened, and the trade became unprofitable. This left hedge funds with no choice but to sell Treasury bonds to unwind their positions and thus long-term Treasury bond yields rose.

Figure 4: Un(explained) Rising Treasury Yields



Source: Cetera Investment Management, FactSet. Data as of 6/18/2025.

High bond yields are problematic for many reasons because they increase borrowing costs. Mortgages and long-term corporate leases are tied to them. Also, the government finances its debt through issuing Treasury bonds, so higher yields mean even more debt. President Trump has spoken many times about how he would like lower bond yields for this very reason. At the end of the day, it is possible that an obscure hedge fund trade may have pushed the world to the tariff negotiating table.

We spent time discussing Treasury markets this quarter because it was such a pivotal period for them. Credit markets also saw volatility though. High yield credit spreads spiked to their highest levels since the pandemic in 2022. While they never got to recessionary levels, that was starting to be a concern. Like the Treasury market, the tariff pause calmed high yield investors' nerves and spreads have since fallen.

Overall, it was a wild ride for bond investors this past quarter, but it appears we will come out of the quarter with only slightly higher yields and even some price gains since the yields were able to offset some of the lower prices in many cases.

Bond volatility is likely to persist as investors and the Fed navigate evolving tariff developments. If negotiations fail, equity markets will likely sell off and bond yields may decline as expected, with the basis trade already behind us. If this happens, bond prices may rise and could serve as a good diversifier against tariff news and equity volatility. Lower-quality bonds have higher yields but may correlate more with equities. If the U.S. dollar continues to weaken, foreign bonds that are unhedged to the dollar may perform well. Just like in equities, diversification is key in fixed income markets.

The Bottom Line

Looking ahead, the economic trajectory will hinge on how key uncertainties unfold - particularly tariff negotiations, Federal Reserve policy, and the labor market. If trade tensions ease through successful negotiations, it may pave the way for improved trade terms and allow the Fed to cut interest rates, supporting economic growth. Inflation remains relatively contained, but consumers still feel the effects of elevated prices and tariffs could pressure goods inflation in the months ahead. The labor market, while softening slightly, remains resilient and is expected to be the primary factor influencing Fed decisions. A stable job market could sustain consumer spending and help buffer against broader economic slowdowns.

In the markets, international equities are expected to remain strong, supported by fiscal stimulus abroad. U.S. large-cap growth stocks have regained momentum, while small and mid-cap companies may offer upside surprises due to lowered expectations. Fixed income markets could be a good diversifier, especially if tariff talks falter. Investors are encouraged to stay diversified across asset classes and geographies. Active management and adaptability will be key to navigating the evolving landscape.

It is easy to get distracted by all the latest headlines. Diversification is prudent, and your Cetera financial professional can help you navigate any uncertainty to keep you focused on your personal goals and objectives.

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A diversified portfolio does not assure a profit or protect against loss in a declining market.

Glossary

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg US Aggregate Bond Index is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. Eligible bonds must have at least one year until final maturity, but the index holdings have a fluctuating average life or around 8.25 years. This total return index is unhedged and rebalances monthly.

The ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. Securities must have a below investment grade rating (average of Moody's, S&P, and Fitch) and an investment grade rated country of risk (average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings). Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of $100 million.

The MSCI EAFE is designed to measure large and mid cap equity market performance of 21 developed markets, including three regions (Europe, Australasia, Far East) excluding the U.S. and Canada. The Index is market-capitalization weighted, covering 85% of the free float-adjusted market cap in each of the 21 countries.

The Russell 1000 Growth index is a subset of the Russell 1000 as measured by three factors: sales growth, the ratio of earnings change to price, and momentum.

The Russell 1000 Value index is a subset of the Russell 1000 as measured by three factors: the ratios of book value, earnings, and sales to price.